

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Nakano Analyst: Jeani Brent Bill Number: AB 465  
Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 02/16/1999  
Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Research Expenses Credit/Conform Alternative Incremental Credit to Federal Formula

### SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would eliminate the provisions that make the state alternative incremental research expenses credit a reduced percentage of the federal credit amount, so that the federal percentages also would apply for state purposes.

### EFFECTIVE DATE

This bill would apply to taxable and income years beginning on or after January 1, 1999.

### LEGISLATIVE HISTORY

AB 1042 (Stats. 1997, Ch. 613), SB 455 (Stats. 1997, Ch. 611), AB 1067, AB 1356, AB 1499 (1997); AB 3408 (1996), SB 38 (Stats. 1996, Ch. 954); AB 365, AB 397, AB 917, SB 681 (1995); AB 2407 (Stats. 1994, Ch. 949); AB 1824, AB 1893, AB 1911 (1993), SB 671 (Stats. 1993, Ch. 881); SB 1853, AB 2508 (1992); AB 274 (Stats. 1990, Ch. 452); AB 802 (Stats. 1989, Ch. 1352); AB 2130 (Stats. 1988, Ch. 11); AB 53 (Stats. 1987, Ch. 1138).

### PROGRAM HISTORY/BACKGROUND

Senate Bill 455 (Stats. 1997, Ch. 611) generally conformed California law to federal law. For purposes of the research credit, SB 455 provided that for 1997 taxable or income years the 1997 changes to the federal research credit do not apply for state purposes.

Assembly Bill 1042 (Stats. 1997, Ch. 613) conformed the California research credit to the 1997 changes to the federal research credit, but reduced the alternative incremental credit by an 11:20 ratio and specified that the changes apply beginning with the 1998 taxable or income years.

AB 1042, enacted after SB 455, chaptered out and thus eliminated the SB 455 provisions that would have made the 1997 federal changes not apply for state purposes for 1997. As a result, state law is fully conformed to the federal alternative incremental credit amounts and any other 1997 federal changes for 1997 taxable or income years. The 11:20 reduction in the federal credit amount, as provided by AB 1042, was to apply beginning with the 1998 taxable or income year.

### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

### Department Director

### Date

**Gerald Goldberg**

**3/23/1999**

However, SB 2798 (Stats 1998, Ch. 323) modified the state alternative incremental credit amounts for the 1998 taxable or income years to 80% of the federal alternative incremental credit amounts.

#### SPECIFIC FINDINGS

**Existing federal law** provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year.

A 20% research tax credit also applies to the excess of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit."

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers, including any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983 (so-called "start-up firms"), are assigned a fixed-base percentage of 3%.

In computing the credit, a taxpayer's base amount may not be less than 50% of its current-year qualified research expenditures. To prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer. Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise allowable) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5%.

A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. Taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses"); and (4) 75% of amounts paid to a research consortium for qualified research if the research consortium is a tax-exempt organization and is organized and operated primarily to conduct scientific research, and the qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the existing research expenses deduction requirements but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

Expenditures attributable to research conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

**Existing state law** conforms with specific modifications to the federal research credit, as follows:

- For corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, the definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
- "Basic research" must be conducted in California to qualify for the California credit.
- Research that has a specific commercial objective may qualify as "basic research."
- The credit percentage is 11% for qualified research and 24% for corporations for "basic research."

To duplicate the federal provision that allows the credit for "basic research" payments only to corporate taxpayers, the B&CTL allows the credit based on "qualified research" expenses and "basic research" payments, while the PITL allows the credit only for "qualified research" expenses.

- The state alternative incremental credit amounts are set at 80% of the federal alternative incremental credit amounts.
- California taxpayers may make the alternative incremental credit election at any one time, instead of having a window period for the making election comparable to that contained in the federal credit. Also, the taxpayer's federal election is not binding for state purposes.
- The state definition of "gross receipts" for purposes of the credit differs from that used in the federal credit.
- The termination dates provided under federal law do not apply to state law. The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

**This bill** would eliminate the provisions that set the state alternative incremental credit amounts at 80% of the federal alternative incremental credit amounts. Therefore, the higher amounts that applied for 1997 again would apply for state purposes beginning with income or taxable starting on or after January 1, 1999.

#### Implementation Considerations

Implementing this bill would occur during the department's normal annual system update.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

Revenue losses under the PITL and B&CTL are estimated to be as follows:

Effective Tax Years After December 31, 1998 Assumed Enactment After June 30, 1999 (in millions)*			
1999-0	2000-1	2001-2	2002-3
(\$25)	(\$30)	(\$30)	(\$35)

\* Rounded to the nearest \$5 million.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

##### Revenue Estimate Discussion

The above revenue impact was estimated as follows. First, the revenue loss resulting from the alternative incremental credit under existing B&CTL was estimated for 1994 using the department's bank and corporation tax samples as well as other corporate financial data.

Next, the revenue loss resulting from the alternative incremental credit under the proposed higher credit rates was estimated. The differences were the bank and corporation tax revenue impact of this bill based on 1994 data. Future revenue losses were extrapolated using the Department of Finance's projected annual growth rates of corporate profits. Finally, the revenue impact under the PITL was assumed to be equal to 1% of the B&CTL impact. Finally, the revenue impact under B&CTL and the PITL were combined to provide an overall revenue impact for this bill.

BOARD POSITION

Pending.